DETERMINANTS OF FOREIGN DIRECT INVESTMENT INFLOW IN AN EMERGING ECONOMY: THE NIGERIA EXPERIENCE

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Abstract:

The resources to finance the optimal level of economic growth and development in Nigeria are in short supply. This is because, Nigerian economy is plagued with rising poverty, low domestic savings, low tax revenue, macroeconomic instability, political instability, unstable exchange rate and limited foreign exchange earnings amongst others. As a result of these, the country inevitably resorts to policy that will enhance the flow of foreign direct investment in order to bridge the gap between the resources available to her and what is required for her advancement. Given these situations, the study examined the determinants of foreign direct investment inflow in Nigeria from 1980-2015 with the use of time series data obtained from the NBS and CBN statistical bulletin. It employed the econometric techniques of co-integration, ECM and Chow test approach to analyze the data. The Augmented Dickey Fuller unit root test result showed that all the variables were stationary at first difference. The Johansen co-integration test result showed that there is a long run equilibrium relationship amongst the variables. The coefficient of the ECM has the hypothesized negative sign and statistically significant at 5% level. The dynamic model is a good fit because the R^2 is 61%. Moreover, the parsimonious ECM result has the speed of adjustment of 84.1% and also showed that exchange rate stability, political stability, economic growth as well as favourable corporate tax were positively and significantly related to FDI in Nigeria during the period of study. The structural break test showed that the determinants of the inflow of FDI in Nigeria before and after the era of stable democracy were significant in explaining the development of the economy. Based on these findings, the study recommends amongst others that; government should create an enabling political

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and investment environment to attract more of foreign investment in Nigeria. Also, government should make concerted effort to increase the annual economic growth rate and make tax friendly policy in order to market the economy and attract foreign investors in the country.

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Keywords: FDI, ECM, co-integration, corporate-tax, political stability, exchange rate and economic growth

1. Introduction

There is fundamentally no either developed or emerging nation in the world without the singular aim of accomplishing economic growth and development. However, this can only be achieved if such economy has adequate resources at its disposal (Chimobi & Igwe, 2010). In many emerging economies, the resources to finance the optimal level of growth and development are in short supply. This is because, their economies are plagued with problems associated with vicious cycle of poverty, low domestic savings, low tax revenue, macroeconomic instability, political instability, unstable exchange rate, limited foreign exchange earnings and availability of natural resources amongst others. As a result of these, emerging economies like Nigeria inevitably resort to policy that will enhance the flow of foreign direct investment in order to bridge the gap between the resources available to them and what is required for their advancement.

Thus, foreign direct investment (FDI) involves an investment made by a company or individual in one country in business interests in another country, in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign company. In Nigeria, many foreign direct investments such as Barclays Bank, Leventis stores, Agip and many more are household names. Indeed foreign direct investments are many in Nigeria.

The significance of foreign direct investment cannot be exaggerated. This is because; it is an important stimulant that facilitates new skills, reasonable business environment, agricultural growth and economic development. Therefore, Nigeria like most other emerging countries has tended to rely much on foreign investment for her growth and development which as a result necessitates the dominance of her economy by foreign investors' in various sectors. This dominance is borne out of the desire to expand their businesses and enhance development (Obayori, Obayori, Inimino & Tubotamuno, 2016). But for such investment to be wooed to the emerging or developing countries like Nigeria there is the need for factor such as; large market size, exchange stability, political stability, increased foreign exchange earnings and availability of natural resources amongst others.

Meanwhile, the variation in Nigeria exchange rate which serves as a measure of unstable macroeconomic hinders the inflow of FDI to the country. For instance, CBN

(2014) statistics revealed that the exchange rate moved from its level of 54K: US $ 1 in 1980 to N 22.05: US $1 in 1994. Further, between the year 2000 and 2014 the exchange rate rose again from N102.11: US $1 to N 161.00: US $1. The official exchange rate released by NBS for the last quarter of 2016 is N 365.00: US $1. Similarly, political stability and favourable tax policy are important for creating a climate of confidence for investors. Unstable political settings whether apparent or real could be a severe restrain for the inflow of FDI as it generates doubts and as well upsurges threats and costs (Obwona, 2003). Thus, the incidence of coup d'état in Nigeria between 1960 and 1998 has hitherto moved the country backward in the quest for FDI inflow. The transition to democracy in the year 1999 is an indicator of stable political environment that tends to attract FDI inflow to the country. Moreover, bureaucracy bottleneck such as obtaining visa entry to Nigeria by foreign investor has not been adequately taken care. In the same way, unimpressive rate of economic growth in the Nigerian economy has been inimical to the inflow of FDI in the country. In fact, in recent time Nigeria was in recession because the economy reported negative growth in the last four quarters of the year 2016.

Therefore, the objectives of this paper are to; examine the impact of exchange stability on foreign direct investment in Nigeria; determine the impact of political stability on foreign direct investment in Nigeria; examine the impact of economic growth on foreign direct investment in Nigeria; and determine the impact of favourable corporate taxation on foreign direct investment in Nigeria. The remaining parts of this study examined literature review, methodology, results and discussion as well as conclusion.

2. Literature Review

The review was done under the following subheadings: theoretical framework and empirical literature.

2.1 Theoretical Framework

Various postulates have been formed to clarify the factors affecting FDI in both the developed and emerging economies. Such postulates/theories include the theories of Vernon (1966), Rugman (1981) and Dunning's (1993). In any case, the principle postulates received in this examination was drawn from Dunning (1993) who suggested that the primary determinants of FDI inflows in an economy are; financial development, access to market, large scale privatization, the level of political strength and stable economy.

Dunning (1977) postulated that FDI is brought about by the recognition of three sets of advantages prominently known as OLI, and they are; ownership, locational and the internationalization motivations advantages. Considering the objectives of the study, emphasis was placed on the locational and internationalization determinants of FDI. The locational determinants of FDI can therefore be summed as the size and

growth of market, availability of raw materials and labour, political and legal environment, government policies availability of infrastructures. All these assisted to figure out which nations are host to the activities of the transcontinental corporations (Erdal and Tatoglu, 2002). Additionally, the internationalization determinants of FDI amongst others include; reduction in tariffs, favourable tax policy, foreign exchange controls and subsidies. Meaning that the internationalization incentive arises in order to exploit imperfections in external markets.

In the words of Lucas (1993) as well as Cernat and Vranceanu (2002), an increase in economic growth will bring about influx of FDI into host countries. In justification, Chakrabarti (2001) and Asiedu (2003) also revealed that economic growth is an important determinant of FDI as a unit or percentage increase in economic growth caused greater FDI inflows.

In the interim, Dunning (1993) eclectic paradigm of foreign direct investment has been criticized because, the theory shows that OLI parameters are not the same from organization to organization. It depends on context and reflects the economic, political, social characteristics of the host country. Along these lines, the targets and techniques of the firms, the magnitude and pattern of production will depend on the challenges and opportunities offered by different types of nations.

2.2 Empirical Literature Reviewed

A great deal of researchers have elucidated the determinants of foreign direct investment inflow in both developed and emerging economies using different methods of analysis which have yielded different results. Few of these eminent scholars include; Nwanko (2006) who examined the determinants of foreign direct investment inflows in Nigeria using the method of OLS with data over the period 1962 – 2003. The result showed that FDI in Nigeria is positively and significantly affected by macro-economic instability, political instability, and the availability of natural resources. Also, market size is positively related with FDI but political stability is negatively related with FDI.

Nurudeen and Abu (2010) used OLS and ECM techniques to analyze the determinant of FDI as to which of the determinant are most important and the effect of deregulation on FDI in Nigeria. The results showed that openness of the economy and inflation are statistically insignificant but positively related to FDI. Similarly, the results showed that infrastructural facilities have an insignificant effect on FDI in Nigeria. Similarly, Obida and Abu (2010) used error correction technique to examine the determinants of foreign direct investment in Nigeria. The results revealed that the market size, deregulation, political instability and exchange rate depreciation of the host country are the main determinants of foreign direct investment in Nigeria.

Idowu and Awe (2014) used CBN data and World Bank Development Index from 1970-2010 to analyzed the determinants of foreign direct investment inflows in Nigeria. The techniques of Granger Causality Test, Johansen Co-integration and the Error Correction Mechanism Estimation Test were applied. The study finds a long run relationship amongst the Foreign Direct Investment variables. It also showed that

Foreign Direct Investment into Nigeria has been relatively low as a result of persistent increase in price level, lack of openness and poor economic growth occasioned by political instability, insecurity, poor infrastructure and systemic corruption.

In summary, the paper reviewed the Dunning electric paradigm theory of FDI which averred that if all the variables that determine FDI are favourable, FDI will contributes meaningfully to the growth and development of the economy. Also, a reviewed of empirical works of eminent scholars such as; Nwanko (2006), Idowu and Awe (2014), Nurudeen and Abu (2010) as well as Obida and Abu (2010) are apts.

Meanwhile, this study is justified in that it deviate from others by analysing the determinants of foreign direct investment from both the political and economic perspective as well as extended the time frame of the study to 2015 which is more current than the earlier studies reviewed. Moreover, economic arguments alone are not sufficient to explain the determinants of FDI in Nigeria; therefore, an econometric analysis was carried out using the techniques of co-integration and ECM as well as chow test. Also, this study tried to evaluate ways to overcome the identified factors which are inimical to the inflow of foreign direct investment in Nigeria in order to enhance growth in the Nigerian economy.

3. Methodology

Since the research is quantitative in nature, the study used time series data from secondary sources. The data required was sourced through publications of; Central Bank of Nigeria (CBN) and National Bureau of Statistics (NBS). The functional and econometrics relationship between the dependent and the independent variables was provided in the following equations;

$$FDI = f\ (ES,\ PS\ EG,\ CT) \qquad\qquad (3.1)$$
$$FDI = \beta_0 + \beta_1 ES + \beta_2 PS + \beta_3 EG + \beta_4 CT + \mu \qquad\qquad (3.2)$$

The model in equation (3.2) was further restated in the log-linear form in order to reduce the problem of multi-collinearity in the model and as well estimate the variables in the same unit of measurement. Thus, the log-linear model is specified as shown below;

$$lnFDI = ln\ \beta_0 + \beta_1\ lnES_t + \beta_2\ lnPS_t + ln\ \beta_3 EG_t + ln\ \beta_4 CT_t + \mu \qquad (3.3)$$

Where: FDI= Foreign Direct Investment (Proxy by aggregate FDI inflow to all the sectors in Nigeria), ES= Exchange Rate Stability (Proxy by exchange rate), PS= Political Stability (Proxy by transition to democracy and captured by dummy variable), EG = Economic Growth (Proxy by GDP), CT = Favourable Company Tax (Proxy by company tax), μ = stochastic random variable, Ln = the logarithmic transformation to the natural base. β_0 = intercept parameter, β_1-β_4 = Slope parameters and t = Time/Period

Apriori Expectation; $\beta_1 > 0$, $\beta_2 > 0$, $\beta_3 > 0$ and $\beta_4 > 0$

3.1 Estimation Technique and Procedure

The study conducted a stationarity test for each variable by employing the augmented Dickey-Fuller unit root tests to check the stationarity properties of each variable in order to avoid any spurious regression. The general form of ADF is estimated by the following regression

$$\Delta Yd_t = \beta_0 + \beta_1 Yd_{t-1} + \Sigma \beta_1 \Delta Yd_i + \delta_t + \mu_t \qquad (3.4)$$

Where: Yd is a time series, t is a linear time trend, Δ is the first difference operator, β_0 is a constant, t-1 is the optimum number of lags in the independent variables and μ is random disturbance term

3.2 Johansen Co-integration Test

The Johansen co-integration technique was conducted to test the existence of long run relationships amongst the variable. Essentially, in the Johansen and Juselius (1990) procedure, two tests statistics are suggested for determining the number of cointegration vectors based on likelihood ratio test (LR). These are the trace test and maximum eigenvalues test statistics. For instance, the trace test (β_{trace}) is defined as;

$$\text{Trace} = -T\Sigma_{i=r+1}^{n} \text{Log} (1-\beta_i) \qquad (3.5)$$

The null hypothesis of the trace statistics is that the number of cointegration vectors is $\geq$ r where r = 0, 1, or 2 against the alternative hypothesis that the number of co-integration vectors = r.

3.3 Error Correction Model

The motivation behind the ECM is to demonstrate the speed of change from the short-run equilibrium to the long-run equilibrium state. The greater the co-efficient of the parameter, the higher the speed of adjustment of the model from the short-run to the long-run. The model specification with an ECM form can be formulated as follows: The model determination with an ECM frame can be written as:

$$\Delta QD_t = \beta_0 + \Sigma \beta_1 \Delta QD_{t-1} + \Sigma \beta_2 \Delta Y_{1t-1} + \Sigma \beta_3 \Delta Y_{2t-1} + \Sigma \beta_4 \Delta Y_{3t-1} + \Sigma \beta_5 \Delta Y_{4t-1} + \delta_1 ECM_{t-1} + \mu_{1-t} \quad (3.6)$$

Where; QD is the dependent variable, $\beta_1 - \beta_5$ are the slope parameters, $Y_1 - Y_4$ are the set of explanatory variables, $\delta_1 ECM_{t-1}$ is the coefficient of ECM, Δ is change and μ is the disturbance term.

3.4 The Chow Test

Is a measurable and econometric test generally utilized to test examine a structural break and show the deviation in the coefficients of two linear regressions on different data sets are equal. Thus, the essence of the chow test is to compare the inflow of FDI in Nigeria vis-à-vis period of stable democracy with that of unstable democracy or military intervention.

Suppose that the model is stated as;

$$YD_t = \alpha + Q\beta_{1t} + P\beta_{2t} + U \qquad (3.7)$$

If the data is divided into two groups, then the equations turn out to be;

$$YD_t = \alpha_1 + Q_1\beta_{1t} + P_1\beta_{2t} + U \qquad (3.8)$$

and

$$YD_t = \alpha_2 + Q_2\beta_{1t} + P_2\beta_{2t} + U \qquad (3.9)$$

The null hypothesis of the Chow test asserts that $\alpha_1 = \alpha_2$, $Q_1 = Q_2$, and $P_1 = P_2$

4. Results and Discussion

Table 4.1: Time Series Properties of the Variables

Variable	t-stat		Prob		Decision
	@ INTERCEPT (C)	@ TREND	@ INTERCEPT (C)	@ TREND	
Log(FDI)	19.32452	18.38086	0.0000	0.0000	Time series @ C and Trend
Log(ES)	16.71167	-0.153246	0.0000	0.8791	Time series @ C only
Log(EG)	129.5544	13.45189	0.0000	0.0000	Time series @ C Trend
Log(CT)	42.47125	32.23710	0.0000	0.0000	Time series @ C and Trend

Note: FDI is Foreign Direct Investment, PS is Political Stability, EG is Economic Growth and CT is Favourable Company Tax

Source: Authors' Computation from (E- view 9.0)

The time series properties in Table 4.1 showed that the variables (FDI, ES, EG and CT) had time series at intercept. This is because their respective t-statistics and probability values were statistical significant at 5% level at intercept. Meanwhile the variables (FDI, EG and CT) had time series at both intercept and trend. This is because their t-statistics and probability values were statistical significant at 5% level at both intercept and trend. Thus, all the variables have common time series properties at intercept. Therefore, the ADF unit root test for the variables was conducted at intercept.

Table 4.2: Unit Root Test

| Variables | ADF Test | Critical Value | | | Order of Integration |
		1% Critical Value	5% Critical Value	10 Critical Value	
FDI	-6.492177 *	-3.646342	-2.954021	-2.615817	1(1)
ES	-4.978631 *	-3.639407	-2.951125	-2.614300	1(1)
EG	-6.878544 *	-3.653730	-2.951125	-2.614300	1(1)
CT	-8.42312*	-3.653730	-2.951125	-2.614300	1(1)

Note: FDI is Foreign Direct Investment, PS is Political Stability, EG is Economic Growth and CT is Favourable Company Tax

Source: Authors' Computation from (E- view 9.0)

The order of integration of each of the series is presented in Tables 4.2 using the ADF tests. The results presented in Table 4.2 depicted that all the variables are homogenous of order one. Therefore, they are integrated at first difference prior to subsequent estimations to forestall spurious regressions. Hence, the entire variables in this study are stationary. This means that the best regression results will be obtained when the above variables are used in model estimation.

Table 4.3: Co-integration Result for the Estimated Model

(Trace Statistics) k=1, r=3	Critical Values (5 %)	Prob	(Max-Eigen Statistics) k=1, r=2	Critical Values (5%)	Prob
112.2184*	69.81889	0.0000	48.27048*	33.87687	0.0005
63.94789*	47.85613	0.0008	31.00257*	27.58434	0.0175
32.94532*	29.79707	0.0210	19.90088	21.13162	0.0736
13.04444	15.49471	0.1132	11.18655	14.26460	0.1451
1.857895	3.841466	0.1729	1.857895	3.841466	0.1729

Source: Authors' Computation from (E- view 9.0)

Note: r= number of cointegrating vectors and k = number of lags in model. * rejection of the H0

The results of both Trace and Max-Eigen statistics revealed the existence of three and two co-integrating vectors respectively in the model. Thus, the hypothesis of no co-integration, H_0, among the variables was rejected. Since the series are co-integrated, then, the output model is estimated using the parsimonious ECM approach.

Table 4.4: Parsimonious Error Correction Mechanism Result for the Estimated Model

Variables	Coefficient	T-Statistics	T-Table	Probability
C	-0.005459	-0.023478	2.0395	0.9815
DLOG(FDI(-1))	-0.277885	-1.672458	2.0395	0.1080
DLOG(FDI(-2))	-0.455869	-3.008287	2.0395	0.0063
DLOG(FDI(-3))	-0.083606	-0.551932	2.0395	0.5863
DLOG(ES(-3))	2.023301	4.181878	2.0395	0.0004
D(PS(-3))	1.739386	2.961064	2.0395	0.0070
DLOG(EG(-3))	0.068008	5.500025	2.0395	0.0002
DLOG(CT(-3))	0.705751	4.690894	2.0395	0.0005
ECM(-1)	-0.841000	-2.405670	2.0395	0.0302
R²= 0.612484	DW-Stat= 2.091422	F-Stat.= 4.544052	F-tab=3.60	F-prob.= 0.002

Source: Authors' Computation from E- view 9.0

The Parsimonious Error Correction Model (ECM) in Table 4.4 indicated that the dynamic model is a good fit. This is so because the variation in the dependent variable (FDI) accounted for 61 percent of the total variation in the explanatory variables (exchange rate stability, political stability, economic growth and favourable company tax) in the model. Also, the model's good fit is further buttressed by high value of f-statistic of 4.544 which is statistically significant at the 5%. The Durbin Watson (DW) value of 2.0914, which is approximately 2.1, suggested that the model is free from positive first order correlation. Thus, the explanatory variables in the model are not serially correlated. The model is therefore good for policy formulation and implementation. Meanwhile, the coefficient of the parameter of error correction mechanism (ECM) has the hypothesized negative sign and statistically significant at 5% level. This showed that about 84 percent disequilibria in the FDI in the previous year were corrected for in the current year. It therefore follows that the ECM rightly corrected any deviations from short run to long-run equilibrium relationship between the dependent and the explanatory variables.

Furthermore, the coefficients of exchange rate stability (ES) is positively signed and statistically significant at 5 percent level. The implication of this result is that stable exchange rate contributed positively to increase the inflow of FDI in Nigeria during the period of study. Thus, the alternative hypothesis was accepted. The finding above is in line with the view of Erdal and Tatoglu (2002) who argued that stable exchange rate affect FDI inflows because they affect a firm's cash flow, expected profitability and the attractiveness of domestic assets to foreign investors.

Also, the coefficient of political stability (PS) is positively related with FDI and statistically significant at 5 percent level. The implication of this result is that stable government contributed positively to increase the inflow of FDI in Nigeria during the period of study. Thus, the alternative hypothesis was accepted. The finding supported the empirical work of Asiedu (2006) who affirmed that while political instability is inimical to inflow of FDI, political stability is a major determine of FDI in an economy. Similarly, the coefficient of economic growth (EG) is positively related with FDI and statistically significant at 5 percent level. Thus, it could be deduced from the result that increase in the growth of the economy will lead to inflow of FDI in Nigeria during the period of study. Thus, the alternative hypothesis was accepted. The finding above alludes to the empirical work of Asiebu (2003).

The coefficient of favourable company tax (CT) is positively related with FDI and statistically significant at 5 percent level. Thus, the result showed that favourable taxation policy will lead to inflow of FDI in Nigeria. Thus, the alternative hypothesis was accepted. Thus, low tax policy enhances the inflow of FDI in the Nigerian economy.

Table 4.5: Structural Break Test Result

Specification: LOG(FDI) C LOG(ES) PS LOG(EG) LOG(CT)

Test predictions for observations from 1999 to 2015

	Value	Df	Probability
F-statistic	31.3589	(17, 14)	0.00000
Likelihood ratio	11.61554	17	0.00228

Sample: 1980 1998
Included observations: 19

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	2.227300	8.036789	0.277138	0.7857
LOG(ES)	0.902615	0.489191	1.845118	0.0863
PS	0.347610	0.801362	0.433774	0.6711
LOG(EG)	-0.127736	0.609983	-0.209409	0.8371
LOG(CT)	0.816275	0.425769	1.917180	0.0759

R-squared	0.887980	Mean dependent var	8.629984
F-statistic	27.74433	Durbin-Watson stat	1.831475
Prob(F-statistic)	0.000002		

Source: Authors' Computation from E-view 9.0

The Chow Test is a test that determines if the coefficients from two regression analyses are the same. Here the structural break test was conducted to compare the inflow of FDI in Nigeria period before and after the era of transition to stable democracy to determine which period command more inflow of FDI in the economy vis-à-vis the political stability, exchange rate stability, economic growth and favourable tax policy. This was done by comparing the f-value in the current periods (1980-1998) and lag periods (1999-2015). The results showed that although the two period's f-values were statistically significant, but the f-value of 27.74433 before the period of stable democracy is less than the f-value of 31.3589 after the period of stable democracy. Thus, the study concludes that the aforementioned determinants of FDI in Nigeria are key to the inflow of FDI in the Nigerian economy and thus impacted on the growth of the economy in Nigeria.

5. Conclusion

The paper examined the determinants of foreign direct investment in an emerging economy; the Nigeria experience from 1980-2015. Thus, the parsimonious ECM

approach was the main econometric tool. Meanwhile, the ADF unit root test results showed that all the variables were integrated at order one. The Johansen co-integration test result showed that co-integration equations exist amongst the variables. Meanwhile, the ECM was conducted to ascertain the speed of adjustment from the short run to long-run equilibrium relationship amongst the variables in the model showed that; exchange rate stability, political stability economic growth and favourable corporate tax have direct (positive) and significant impact on FDI in Nigeria during the period of study. The structural break test showed that the determinants of the inflow of FDI in Nigeria before and after the era of stable democracy were significant in explaining the development of the economy.

The study therefore concluded that exchange rate stability, political stability, economic growth and favourable corporate tax promote the inflow of FDI in the Nigerian economy. Thus, it was asserted that FDI is key to Nigeria's prosperity in the new millennium if enabling political environment is created for more foreign investors to thrive. Also, government should allow naira to appreciate more since it will reduce the dollar price of some ailing indigenous companies, thus attract more foreign investment (in form of mergers and acquisition). Similarly, government should make concerted effort to increase the annual economic growth rate and tax friendly policy in order to market the economy and attract foreign investor to the country.

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